TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Legend:

Company A =

Plan X =

Dear

This letter is in response to a ruling request dated May 10, 2002, submitted on your behalf by your authorized representative, as supplemented by letters dated May 22, 2002, and July 26, 2002. The request concerns the consequences for an employee stock ownership plan ("ESOP") under Internal Revenue Code ("Code") sections 4975(d)(3), 4975(e)(7), and 415(c)(2) of a distribution of earnings by a Subchapter S corporation to the ESOP which will be used to repay an exempt loan.

The following facts and representations have been submitted in support of the rulings requested:

Company A established Plan X, a stock bonus plan, effective January 1, 1986. Plan X is a leveraged ESOP which is intended to meet the requirements of Code sections 401(a) and 4975(e)(7). The most recent favorable determination letter for Plan X is dated April 11, 2001.

Plan X borrowed funds from Company A to purchase Company A common shares. Company A, through its authorized representative, represents that these loans ("Exempt Loans") are exempt within the meaning of section 54.4975-7(e) of

the Excise Tax Regulations ("regulations"). Collateral for the Exempt Loans consists of unallocated Company A stock held in a suspense account. As contributions are made to Plan X by Company A, Plan X makes payments of principal and interest on the Exempt Loans and a pro rata portion of the Company A shares in the ESOP suspense account are released and allocated to participant accounts in Plan X pursuant to the allocation formula specified in Plan X.

Company A elected to be taxed under Subchapter S of the Code effective January 1, 1998. To this date, Company A continues to be an electing Subchapter S corporation under section 1361 of the Code. Company A maintains an accumulated adjustment account ("AAA") in accordance with section 1368 of the Code. The AAA is not increased by capital contributions.

Company A has, in the past, made S Corporation earnings distributions proportionately to all shareholders of Company A, including Plan X. In past years, Company A has limited such earnings distributions to the minimum amount necessary to provide individual shareholders sufficient cash with which to pay their income tax resulting from being shareholders of Company A. Company A intends to continue making such earnings distributions to its shareholders in 2002, and also intends to make a one-time additional S corporation earnings distribution from the AAA in an amount up to $4.00 per share in order to allow shareholders to receive a portion of Company A's accumulated and undistributed profits. The 2002 S corporation earnings distributions would represent dividends under Code section 301 if Company A were a C Corporation rather than an S corporation.

Based on the above facts and representations, the following rulings have been requested:

1. Company A's S corporation earnings distributions to Plan X in 2002 with respect to unallocated Company A shares held by Plan X may be used to make principal and interest payments on the Exempt Loans without violating the requirements of section 4975(d)(3) of the Code and its accompanying regulations.

2. Company A's S corporation earnings distributions from its AAA to Plan X in 2002 with respect to allocated and unallocated Company A shares held by Plan X will not constitute "annual additions" within the meaning of section 415(c)(2) of the Code and its accompanying regulations.

Code section 401(a) provides that a trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an

employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section if certain requirements are met.

Code section 4975(e)(7) generally defines an ESOP as a defined contribution plan which is a stock bonus plan which is qualified under Code section 401(a), and which is designed to invest primarily in qualifying employer securities.

Code section 4975 imposes a tax on prohibited transactions, but provides an exemption in section 4975(d)(3) for a loan to a leveraged ESOP (as defined in section 4975(e)(7)) if such loan is primarily for the benefit of participants and beneficiaries of the plan. Requirements concerning the interest rate and collateral must also be met.

Section 54.4975-7(b)(2)(ii) of the regulations provides that exempt loans will be subjected to special scrutiny to ensure that they are primarily for the benefit of participants and their beneficiaries.

Section 54.4975-7(b)(3) of the regulations states that an exempt loan must be primarily for the benefit of the ESOP participants and their beneficiaries, and that all of the surrounding facts and circumstances will be considered in determining whether the loan satisfies this requirement. It further states that no loan will satisfy this requirement unless it satisfies the requirements of section 54.4975-7(b)(5) of the regulations.

Section 54.4975-7(b)(5) of the regulations states in part that no person entitled to payment under the exempt loan shall have any right to assets of the ESOP other than (i) collateral given for the loan, (ii) contributions (other than contributions of employer securities) that are made under an ESOP to meet its obligation under the loan, and (iii) earnings attributable to such collateral and the investment of such contributions. Section 54.4975-7(b)(5) further states that payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years.

Section 54.4975-11(c) of the regulations provides that all assets acquired by an ESOP with the proceeds of an exempt loan under Code section 4975(d)(3) must be added to and maintained in a suspense account. They are to be withdrawn from the suspense account by applying the applicable regulations as if all securities in the suspense account were encumbered.

In the present case, since the unallocated shares are held in the suspense account as collateral for the Exempt Loans, the earnings attributable to such shares may be used to make payments on the Exempt Loans to the extent that

these earnings are from the AAA of Company A. Accordingly, with respect to ruling request one, we conclude that to the extent that Plan X uses the earnings received on unallocated shares of Company A stock held in the suspense account to make principal and interest payments on the Exempt Loans, the transactions will not cause the Exempt Loans to fail to satisfy section 4975(d)(3) of the Code if such earnings are from the AAA maintained by Company A.

Code section 415(a) provides, in pertinent part, that a trust which is part of a pension, profit-sharing, or stock bonus plan will not constitute a qualified trust under section 401(a) of the Code if, in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitation of subsection 415(c) of the Code.

Code section 415(c)(1) provides that contributions and other additions with respect to a participant exceed the limitations of this subsection if, when expressed as an annual addition (as defined below), such annual addition is greater than the lesser of $40,000, or 100 percent of the participant's compensation.

Code section 415(c)(2) defines an "annual addition" as the sum for any year of employer contributions, employee contributions, and forfeitures.

Section 1.415-6(b)(2)(i) of the federal Income Tax Regulations (the "regulations") provides that the Commissioner may, in appropriate cases, considering all of the facts and circumstances, treat transactions between the plan and the employer or certain allocations to participant accounts as giving rise to annual additions.

Section 1.415-6(g) of the regulations sets forth special rules for ESOPs. Section 1.415-6(g)(5) provides that for purposes of applying the limitations of Code section 415(c), the amount of employer contributions which is considered an annual addition for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.

Section 54.4975-11(d)(3) of the regulations provides, in part, that income with respect to securities acquired with the proceeds of an exempt loan shall be allocated as income of the plan except to the extent that the ESOP provides for the use of income from such securities to repay the loan.

Section 54.4975-11(a)(8)(ii) of the regulations provides that an ESOP will not fail to meet the requirements of section 401(a)(16) of the Code merely because annual additions under section 415(c) of the Code are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to

securities allocated to participants.

Company A's S corporation earnings distributions from its AAA to Plan X are not employer contributions, employee contributions, or forfeitures, and hence do not fall within the definition of annual additions as defined in Code section 415(c)(2). As stated previously, section 54.4975-11(a)(8)(ii) of the regulations permits the calculation of annual additions for ESOP participants on the basis of employer contributions used to repay an exempt loan rather than on the basis of the value of employer securities allocated to participants' accounts. However, since the amounts that will be used to repay the loan are not employer contributions, they will not constitute annual additions under section 54.4975-11(a)(8)(ii) in this situation.

As noted above, section 1.415-6(b)(2)(i) of the regulations provides that the Commissioner may, in appropriate cases, considering all the facts and circumstances, treat certain allocations to participant accounts as giving rise to annual additions. In our view, the facts and circumstances of the present case do not support the recharacterization of the earnings distributions as annual additions under the authority of section 1.415-6(b)(2)(i). We believe that these amounts constitute distributions of earnings to Company A shareholders and not contributions or other additions with respect to Plan X participants.

Therefore, with respect to ruling request two, we conclude that the S corporation earnings distributions made by Company A from its AAA to Plan X with respect to either allocated or unallocated Company A shares held by Plan X will not constitute "annual additions" within the meaning of section 415(c)(2) of the Code.

The above rulings are based on the assumption that the loan from Company A to Plan X is exempt under Code section 4975(d)(3) and that Company A's AAA satisfies the requirements of Code section 1368 at all relevant times. It is also assumed that Plan X is otherwise qualified under Code sections 401(a) and 4975(e)(7).

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations that may be applicable thereto.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling letter was prepared by Neil Sandhu (I.D. # 50-07355) of this Group. He may be contacted at (202) 283-9579.

Pursuant to a power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representatives.

Sincerely yours,

Alan C. Pipkin
Manager, Technical Group 4
Employee Plans